A SUBSIDIARY OF

LG&E ENERGY

COMMONWEALTH OF KENTUCKY

BEFORE THE

PUBLIC SERVICE COMMISSION

In the matter of:

APPLICATION OF LOUISVILLE	)	
GAS AND ELECTRIC COMPANY	)	CASE NO. 98-426
FOR APPROVAL OF AN	)	
ALTERNATIVE METHOD OF	)	
REGULATION OF ITS RATES	)	
AND SERVICE	)	

FILED OCTOBER 12, 1998

COMMONWEALTH OF KENTUCKY

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PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR APPROVAL OF AN ALTERNATIVE METHOD OF REGULATION OF ITS RATES AND SERVICE	))))	CASE NO. 98-426

APPLICATION, TESTIMONY AND EXHIBITS

OF

LOUISVILLE GAS AND ELECTRIC COMPANY

LG&E ENERGY

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Vice President - Regulatory Affairs

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October 12, 1998

Helen C. Helton
Executive Director
Public Service Commission
730 Schenkel Lane
P.O. Box 615
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RE: In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR APPROVAL OF AN ALTERNATIVE METHOD OF REGULATION OF ITS RATES AND SERVICES	))))	**CASE NO. 98-426**

Dear Ms. Helton:

Enclosed for filing in the above-referenced case please find the original and ten (10) copies of the application of Louisville Gas and Electric Company ("LG&E") for approval of an alternative method of regulating its electric rates and services. The proposed alternative method meets the long-term needs of our customers for continued low rates and excellent service. In addition, it meets the goal set by the Commission in its Order approving the merger of KU Energy Corporation into LG&E Energy Corp. in Case No. 97-300, of "providing incentives to utilities and a sharing of resulting benefits with ratepayers."

This will be accomplished through a regulatory process that includes financial incentives for LG&E to find new cost-saving ways to provide electricity, and ultimately, to share those savings with our customers.

Accompanying the application are the prepared direct testimonies and supporting exhibits of the following witnesses:

1. Victor A. Staffieri, Chief Financial Officer, LG&E Energy Corp.;

2. Dr. Mark Newton Lowry, Vice President, Regulatory Strategy, Christensen Associates;

3. Donald F. Santa, Jr., Senior Vice President, Deputy General Counsel, LG&E Energy Corp.;

4. Ronald L. Willhite, Vice President, Regulatory Affairs, Louisville Gas and Electric Company;

5. Dr. Lawrence Kaufmann, Senior Economist, Christensen Associates; and

6. Stephen R. Wood, President, Louisville Gas and Electric Company.

In its September 12, 1998 merger Order, the Commission directed LG&E and Kentucky Utilities Co. ("KU") to file detailed plans addressing the future regulation of their rates. As the Commission's Order noted, the current regulatory environment in Kentucky has worked well and accomplished the goals of providing reliable service to customers at rates far below nearly all regions of the country, as well as attractive returns for shareholders.

The Commission also noted that proposals to introduce competition into the electric utility industry likely will create a new regulatory environment, and traditional ratemaking methods may not serve the interests of customers and shareholders during the transition to this new environment. Already, changing market conditions and customer expectations demand a change in the method of regulation. Additional managerial, operational and marketing flexibility will be necessary in the near future to maintain the enviable position energy consumers in Kentucky now enjoy.

LG&E's application, supporting testimony, and corresponding exhibits present a proposal for an alternative method of regulation based primarily on key performance criteria that measure how well the Company serves its customers and provides incentives for LG&E to maintain and improve on its already excellent service and low rates. The method LG&E proposes will lead to even more efficient fuel procurement, more efficient generation, improved transmission and distribution, and improved customer service operations. These benefits are in addition to the merger surcredit and five-year rate cap placed into effect July 1, 1998, as a result of the merger. The plan includes a proposed Electric Performance Based Rate ("EPBR") tariff to ensure that customers share in the benefit of LG&E's increased efficiencies and improved operations. An illustrative EPBR tariff is included in an exhibit to my testimony.

As Dr. Mark Newton Lowry points out in his testimony, noted regulatory economist Dr. James C. Bonbright in 1961 addressed the relationship between regulation and competition.

> Regulation, it is said, is a substitute for competition. Hence its objective should be to compel a regulated enterprise, despite its possession of a complete or partial monopoly, to charge rates approximating those which it would charge if free from regulation but subject to the market forces of competition. In short, regulation should be not only a substitute for competition, but a closely imitative substitute.

Now is the time for Kentucky to move to performance-based ratemaking because it more closely simulates the competitive marketplace and encourages innovation, efficiency, cost-reduction, and improved service quality. This type of regulation is especially important during the current transition from a regulated industry to a more freely competitive market. This is because performance-based ratemaking simultaneously aligns customer and shareholder interests. Essentially, it puts into place a method of regulation that allows the Commission to produce economic pressures and a management discipline similar to those prevalent in competitive markets.

Electric utility customers are increasingly focused on the price they pay for their electricity rather than a utility's costs. Performance-based regulation will help LG&E meet many of our customers' expectations for a more competitive electric market and help, during the transition period, communicate with customers about how a competitive electric market will work.

Even in the unlikely event that competition does not come to Kentucky, our customers and shareholders will benefit from the innovation, efficiency, cost-reduction, and improved service quality that will flow from performance-based regulation.

The performance-based ratemaking plan proposed by LG&E consists of five components. First, LG&E's current fuel clause will be withdrawn and replaced with a component of the proposed EPBR rate schedule that compares changes in actual fuel costs with changes in a fuel index based on a five-state region of fuel cost data reported to the Federal Energy Regulatory Commission. To the extent changes in actual costs exceed changes in the index, LG&E's recovery will be limited to the change measured by the index. In other words, LG&E must at least do as well as the other utilities in the index or shareholders will pay the difference. However, if LG&E does better than the index, customers and the Company will benefit equally from the superior Company performance. This first component will encourage LG&E to manage its fuel costs aggressively while guaranteeing that customer exposure to fuel cost changes is no greater than what is reflected in the index.

The second component recognizes the savings obtained by the joint dispatch of LG&E's and KU's generating plants after consummation of the merger. In the merger proceeding, the companies estimated that these savings would total approximately $36 million over five years. During the first three months after the merger, joint dispatch has provided LG&E's customers with $0.8 million in savings.

The third component measures the performance and utilization of LG&E's and KU's generating plants against their best composite performance mark set between 1991 and 1997. The performance measures that will be used are the Capacity Factor and Equivalent Availability Factor. The former measures the utilization of a generation unit, while the latter measures the annual availability of installed capacity to meet load requirements. As the companies' performance in operating their plants surpasses the benchmarks customers will share benefits up to $5 million annually under LG&E's component.

The fourth component is a balancing element that will encourage LG&E to maintain and improve upon its levels of service quality, customer satisfaction, and safety, many of which are now considered "best-in-class." This quality of service element ensures a continued investment in practices and equipment that advance service quality, customer satisfaction, and safety. LG&E proposes that its service quality and level of customer satisfaction be measured against an objective set of six benchmarks, and that it be rewarded for bettering the benchmarks and penalized for failing to reach them. LG&E proposes that the benchmarks include measures of outages, customer satisfaction, and employee safety. The plan sets annual rewards and penalties within a range of a negative $5 million to a positive $5 million.

The fifth and final component of LG&E's performance-based ratemaking plan will provide LG&E with the ability to respond to customer needs and demands for customized rates and services. The utilities could work together with customers within set parameters to develop rates and services that are tailored to their needs and reflective of the value provided, but in no case would the rates be less than the marginal cost to provide the service. Customers would be allowed to choose between current base rates and the customized services. Other options would also be offered if they have no revenue requirement effect, such as time-of-day rates for smaller industrial, commercial, or residential customers.

This filing contains LG&E's response to the Commission's directive that the company file detailed plans addressing future rate regulation. KU's response, which is identical to LG&E's in all material respects, is being filed concurrently under separate cover in Case No. 98-474. Applicable data specific to each company would be used to implement the proposed ratemaking methods.

Copies of this letter, the application, and its accompanying testimony and exhibits have been served today on the persons noted on the attached service list.

Respectfully submitted,

Ronald L. Willhite

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